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CURRENCIES AND CREDIT MARKETS

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"At the end of the day, the argument is not about an abstraction called sterling or dollar - whatever the economists would have you believe. It is about giving ourselves, our children and their children a richer and fuller life than we have been able to provide in the past ... Only in these terms do we face a moral crisis."

Britain on Borrowed Time, G. Jones and M. Barnes
Penguin Books, 1967

HIGHLIGHTS

Special factors may feed the odd rally on Wall Street and elsewhere, but this fact remains incontrovertible: Deprived of new money, the Great Financial Bubble must die.

In the meantime, the trends of the dollar, Wall Street and the U.S. economy — all intertwined — remain the key points of confidence for investors around the world. How strong are they really?

We investigate this key question in this letter and furnish important new evidence of the forces that are sure to break the U.S. recovery and choke the U.S. financial markets. Similar trends apply to some other countries, as well.

There are two key over-riding factors: first, disastrous liquidity trends; and second, unsustainable, grossly inflated consumption. This is the most ill-structured economic recovery in the U.S. ever.

We identify three key reasons for continuing long-term dollar weakness. It's only because of two special and temporary factors that the dollar hasn't fallen more sharply to this point.

The Greenspan Fed is widely praised for its cunning role in stabilizing the U.S. banking system while stimulating the recovery. In reality, it only diverted one crisis by stalling for a much larger one later. In creating an unprecedented financial bubble, it has caused even greater imbalances.

There is a new and highly dangerous trend in the U.S. banking system: A total lack of deposit growth. This has forced the U.S. banks to fund their lending and investments by borrowing in the Euro-market. This subjects the dollar to a dangerous vulnerability.

Looking at global markets, the deficit and debtor countries are the biggest losers. Development in the markets highlight an unpleasant truth: International investors will no longer be able to finance their soaring external deficits indefinitely.

The giant, runaway mania that the Fed has nurtured during the past few years — the Great Financial Bubble — inevitably will go the way of all bubbles — a huge financial bust. In our view, the stage is set for a crash. Only the timing is up for question.

For conservative investors, our advice remains almost monotonous: Preserve and increase liquidity at all costs. Shorter-term bonds in the hard-currency countries are the safest haven.

THE HARBINGERS OF A CRASH

What to make of this? On February 4, 1994, a minuscule rate hike by the Fed triggered a global bond market crash — even though Wall Street had wished for precisely such a sinecure, seeing it as a pre-emptive strike against rising inflationary expectations. On August 11th, modest rate hikes by the central banks of Sweden and Italy — certainly not the most influential monetary authorities in the world — again sent stock and bond markets spinning. Here again, financial markets had demanded these actions in various ways. Yet, when these measures were delivered, markets took fright. Just why are financial markets so hyperactive?

The logic behind all the recent financial market palpitations is supposedly that the Swedish and Italian rate increases marked the bottom of the European interest-rate cycle. These moves, therefore, were taken as a harbinger of rate hikes all over Europe. Alas, the reality set in that there isn't a major central bank left in the western world that's inclined towards monetary ease anymore . . . at least until the next recessions hit.

Remarkably, even the dollar took a heavy beating following the two European rate hikes, losing four pfennigs against the mark in just 24 hours. Reading the media's explanation for this, we couldn't quite believe our eyes. To quote the Wall Street Journal: "*Dollar falls as investors seek safe haven in the German currency.*" In other words, currency turmoil in Europe sparked a flight, not to the dollar, as in years past, but away from it. Truly, the world has changed.

Unbelievably, in the meantime, despite the smarting bond market losses, the underlying demeanor of financial markets remains optimistic and bullish. Virtually the entire world's financial machinery is vigorously practicing denial, continuing to churn out predictions of perpetual prosperity. It's truly remarkable that though the thunder clouds are looming on the horizon that most everyone continues to plan for a financial picnic. While it may take time to change the long-conditioned, deeply-ingrained optimism of investors around the world, we remain convinced that the bell has rung. The bust of the Great Financial Bubble has begun. Contrary trends will only be temporary, though thankful, interludes. If and when they occur, they should be seized as opportunities to build liquidity.

UNPRECEDENTED VULNERABILITY

The salient point in the case of Sweden and Italy is that both are struggling with abnormally large budget deficits, weak currencies and political upheavals. Thus the specific motives for their moves were obvious: The defense of their currencies. Predictably, they failed. Currency markets, conditioned by the ERM (European Rate Mechanism) crises of the past two years, interpreted these modest actions as signs of weakness, not strength. Attracting the sharp-eyed currency vultures from afar, the lira and the krona promptly crumbled.

But actually, the explanations for these events based on the interest-rate cycle or any other claimed fundamental are no more than expedient afterthoughts. They're designed to plug a void created by ignorance and therefore miss the key point: What's plainly obvious in the markets' violent reactions to these trivial rate hikes is the unprecedented vulnerability of the world's monetary and financial system.

Few observers want to acknowledge this chilling fact either because they don't understand or because they don't want to ponder its true cause. The fact is this: Huge international imbalances and the after-effects of a speculative frenzy unmatched in history continue to overhang the world currency and financial markets. So far, the first leg of the global bear market in bonds has done little to unwind these excesses.

Global Capital Market Trends

Global Equities

Selected Markets, % Change

Country (August 23)	Month	YTD	Y-Y	Vs. 12-Mos. Hi	Vs. 12-Mos. Lo
Australia	-0.4%	-4.7%	6.9%	-11.1%	7.8%
Canada	1.6%	-0.2%	6.4%	-5.5%	10.7%
France	-3.3%	-10.7%	-5.3%	-14.2%	6.2%
Germany	-1.8%	-8.3%	7.9%	-8.3%	10.2%
Hong Kong	-2.8%	-23.5%	27.6%	-24.0%	27.7%
Japan	-0.2%	12.2%	-1.7%	-4.4%	13.2%
Mexico	11.4%	5.7%	42.8%	-2.9%	50.6%
Spain	-3.7%	-8.3%	-3.6%	-16.1%	3.9%
U.K.	3.0%	-6.4%	2.7%	-9.1%	10.4%
U.S.	1.3%	-0.1%	0.9%	-2.6%	5.1%

Source: FTA Indices

Global 10-Year Interest Rates

Selected Markets		Basis Point Change				
Country (August 24)	Present Rate(%)	Month	YTD	Y-Y	Vs. 12-Mos. Hi	Vs. 12-Mos. Lo
Australia	9.54	-18	272	253	-28	318
Canada	9.16	-43	211	191	-68	240
France	7.31	53	221	166	0	221
Germany	6.84	44	173	104	0	173
Japan	4.34	32	162	50	0	163
Spain	10.37	64	289	179	-7	319
U.K.	8.28	36	254	180	-2	254
U.S.	7.28	-2	146	179	-8	194

Source: Financial Times

Exchange Rates

Versus U.S. Dollar		% Change				
Country (August 24)	Present Rate	Month	YTD	Y-Y	Vs. 12-Mos. Hi	Vs. 12-Mos. Lo
Australia ($)	1.35	0.2%	8.3%	9.9%	-0.2%	12.6%
Canada ($)	1.38	0.5%	-3.9%	-4.4%	-6.2%	1.0%
France (FF)	5.28	3.0%	10.6%	9.7%	0.0%	11.4%
Germany(DM)	1.54	3.4%	11.3%	7.6%	0.0%	12.1%
Japan (Yen)	98.4	1.9%	11.8%	5.4%	-0.4%	12.4%
Spain (Pta)	128.5	2.0%	10.1%	5.3%	-0.3%	11.9%
U.K.(Sterling)	1.35	1.9%	4.9%	2.9%	-0.3%	6.1%

But, to us, the bursting of the speculative bubble in global bonds markets is a key bellwether. It most likely marks the secular turn in the tide of international financial flows. And so, the world's deficit countries are rediscovering an ugly truth: Deficits, growing ever larger, can't be financed into eternity.

It was simply ridiculous to presume that huge current-account deficits would be financed automatically. What we see now is that the meltdown in the bond markets has led to a sharp contraction in international liquidity. Cross-border credit flows have fallen dramatically during the first and second quarters of this year, according to the Bank of International Settlements in Basle, Switzerland. Such developments tend to put the currencies of the deficit countries under mounting pressure.

The table on the next page ranks some key countries in terms of their current-account deficits, external debt or assets and government deficits. Over time, shrinking global liquidity will force offending countries to make the painful internal adjustments which they have so far managed to avoid.

For now, though, there still remains a comforting belief that the steep drop in long-term bond prices just reflects a temporary unwinding of speculative investment positions. Everywhere — in brokers' reports especially — we read that the bond market gyrations have no basis in fundamentals ... that they have overreacted. These excuses, however, don't stack up with the facts. The bond market declines have taken place against a backdrop of extremely thin trading. That suggests that many speculators and investors remain locked into their loss-making positions.

The general unwillingness to liquidate bond investment positions is being buoyed by hopes for a future rally in fixed-income markets that will diminish or eliminate current losses. After all, most financial pundits seem unanimous in promoting this view. But the probability of such a rally remains questionable. In our view, it simply can't happen. Why? An unprecedented imbalance between the supply of savings and the global demand for capital and credit will keep global bond markets under heavy pressure for a long time to come.

WHAT IS REALLY DRIVING INTEREST RATE TRENDS?

The central argument of the bond optimists is that long-term rates are far too high relative to global inflation rates. Citing meaningless averages for the postwar period, not for one moment thinking about causality, they croon that real rates are unsustainably high. But as we have repeatedly explained, the belief that inflation or inflationary expectations are the chief determinants of long-term interest rates is the cardinal error in today's market thinking. All the same, it is a convenient fiction for policymakers and markets speculators since it allows them to ignore the corrosive effects of low savings rates and large budget deficits.

The basic function of interest rates is to match the demand for credit and capital with the supply of available savings. But not to forget, depending on the monetary policy, savings can be supplemented over the short-run from a variety of inflationary sources. That's exactly what happened in recent years in unprecedented fashion. By boosting inflationary flows into the securities markets, monetary looseness drove long-term interest rates to excessively-low levels.

COUNTRY FINANCIAL COMPARISONS

All as a % of GDP, 1993

	Net Foreign (Debt)/Assets	Current-Account Surplus/Deficit	General Budget Balance
Canada	-26.2%	-3.5%	-5.5%
Australia	-47.5%	-3.8%	-3.0%
Italy	-9.0%	1.3%	-9.7%
U.K.	-12.4%	-1.7%	-6.4%
Sweden	n/a	-0.2%	-10.7%
U.S.	-17.2%	-1.7%	-2.6%
France	n/a	0.9%	-5.9%
Germany	10.5%	-1.1%	-2.9%
Japan	18.3%	3.1%	-1.9%

Source: OECD

It follows that record-low savings and continuing-high budget deficits in many of the world's major industrial countries should result in structurally high interest rates. But since 1990, a number of forces have turned this relationship on its ear. Extreme U.S. monetary ease, a steep yield curve, reckless use of financial leverage, and a bond buying frenzy mainly by banks and non-banks, have combined to drive long-term rates to extraordinary lows. As is well known, this prolonged, aggressive monetary ease by the U.S. Federal Reserve only had a very muted effect on the real economy for a considerable period of time. Instead, monetary largesse quickly fuelled the most rampant, most globalized speculation in financial assets and instruments in history.

DEFICIT COUNTRIES IN JEOPARDY

Though the bond crash was global, it impacted national bond markets very differently. (See the market performance table on page 3 for a perspective.) Why the extreme divergence? The obvious factor that explains the differences are the current-account deficits. The debtor and deficit countries with the largest current account deficits and external debt (owed to foreign savers) are the ones that suffered the biggest bond market losses.

For the very same reason, it is these deficit countries that have growing currency troubles. The U.S., Canadian and Australian dollars, the British pound, Spanish peseta, Italian lira, Swedish krona. — to name the major ones — are all in a bear trend.

After long last, we think we are witnessing a permanent sea-change in the willingness of financial markets to accommodate the deficit countries. As long as excess liquidity was sloshing around the world, they had no difficulty in funding their outsized balance-of-payments and budget deficits. But now that international investment and hot-money flows are drying up, their currencies and financial markets are starting to be troubled.

The markets haven't grasped the rather obvious fact that the generous accommodation of huge, persistent balance-of-payments deficits in the 1980s and early 1990s was an historic abnormality. It used to be conventional wisdom that payments deficits reflected domestic overborrowing and overspending . . . in other words, vices not virtues. This was recognized as having an inflationary cause. Therefore, payments deficits were enough to trigger currency turmoil very quickly in the past. As long as such market behaviour prevailed, the international payments system was self-correcting and in rough balance over time. Trade imbalances therefore remained modest. Countries that stepped over the line were promptly admonished and forced to make internal adjustments.

UNPRECEDENTED IMBALANCES

All semblance of international balance ended in the early 1980s. Imaginative economists, faced with soaring trade deficits, turned this old wisdom upside down with nice sounding new theories. They literally glorified current-account deficits, arguing that they were the hallmark of economic dynamism and growth, not inflation. Surplus countries, on the other hand, were denigrated as low-growth countries that had little productive use for this money and therefore were left with no choice but to export their surplus capital to the fast-growing debtor countries. Little attention was given to the matter of what the money was actually used for; consumption was considered just as virtuous as investment spending.

This caused a revolution in the financial and currency markets. In blind pursuit of higher yields, international investors and speculators poured money into the higher-yielding markets and currencies of the deficit countries. For much of the 1980s, the world was turned topsy-turvy. The deficit countries had the strong currencies, the surplus countries the weak ones. By flooding the deficit countries with money, investors actually freed them from any need for restraint and adjustment. Not surprisingly, in the absence of any such discipline, deficits exploded.

This open-ended tolerance of international credit markets left a dangerous legacy —unprecedented levels of debt, nationally and internationally. By 1993, the U.S. cumulative current-account deficit reached 17.2% of Gross Domestic Product (GDP). But by far the biggest basket cases are Australia (47.5% of GDP) and Canada (26.2%). Next comes Britain with net foreign debt of 12.4% of GDP (despite its huge oil revenues), and Italy with 9%. (See the table on the opposite page).

This debt buildup of the deficit countries had its mirror image in the creditor countries. By 1993, Japan had amassed a cumulative surplus of 18.3% of GDP; Germany's had grown to 10.5% of GDP. Yet, the perversity of market logic was such that the whole world was bearish on the yen and the mark — the currencies of the two major surplus countries — and bullish on the deficit-plagued U.S. dollar and most other deficit currencies including the Canadian and Australian dollars and the Spanish peseta.

Indeed, early this year, conventional market wisdom held that the dollar had nowhere to go but up. It was a virtual certainty as far as the consensus viewpoint was concerned. Accelerating U.S. economic growth, coupled with monetary tightening and rising U.S. short-term interest rates would compare favourably to economic weakness, monetary easing and falling interest rates in Europe and Japan. While the logic was correct, the facts were wrong.

THREE KEY REASONS FOR DOLLAR WEAKNESS

Reviewing trends this year, economies and short-term interest rates behaved about as expected with the possible exception that economic growth has surprised on the upside both in the U.S. and Europe. The Japanese economy has continued to founder. Nonetheless, the dollar refused to follow the script. Instead of rising as predicted, it fell into the tank — to a yearly low against the D-mark and an all-time low against the yen — much to everybody's astonishment and horror.

In the past, a cyclical mismatch between a strong U.S. economy and weak European and Japanese economies could usually be counted on to boost the dollar. This happened most spectacularly during the 1983-84 recovery. The dollar then soared toward DM 3.24 and Yen 250, even though the U.S. trade and current-account deficits exploded. Essentially what happened was that the U.S. financial markets pulled in foreign funds at a much faster rate than the U.S. current account deteriorated.

We recall this episode because comparing that period to the present situation immediately reveals what Wall Street has blindly overlooked and why the traditional cyclical pattern has failed to work its normal magic on the U.S. dollar this time. We see three key reasons why this happened.

First, the net investment position of the U.S. In 1983, the United States' reputation as a chronic deficit country was still in its infancy. Since then, the U.S. net international investment position has swung from a positive balance of $358.7 billion to a negative $555.7 billion. The difference between then and today is this: In 1983, the world was massively short dollars; today it's massively long.

A second contributing factor to dollar weakness is U.S. monetary laxity. In 1983-84, the Federal Reserve fought inflation with extremely tight money, pushing both short- and long-term rates to sky-high levels and pulling other world rates up with it. Short- and long-term rates peaking at 10 to 14%, respectively, exceeding German rates by 4-5 percentage points. Today, U.S. monetary policy remains very loose; its short-term interest rates are at best flat to other world rate levels. Though the Fed's modest rate hikes have shaken the overleveraged financial markets, they were more symbolic rather than real acts of monetary tightening ... certainly very timid compared to the no-nonsense policies of the Volcker Fed of the 1980s.

The third factor contributing to the dollar's demise is the relative appeal of U.S. financial assets. During the 1980s, the dollar was underpinned by rising U.S. asset prices which attracted strong foreign dollar buying for financial and real investment. Now, better performing foreign markets have been luring U.S. investors offshore in unprecedented numbers.

Last year, for the first time in history, the United States recorded both a huge current-account deficit ($103 billion) and a long-term capital-account deficit. U.S. net purchases of foreign securities rose to $187 billion, while U.S. direct investments abroad totalled $48 billion. Adding these figures together, over $338 billion needed to be financed through capital inflows or the accommodating transactions of central banks.

What ails the dollar is obvious: an appalling global oversupply stemming from the deficits of both its current and long-term capital accounts. It's only the continuation of a trend that has progressively worsened over the entire postwar period, especially since the early 1980s.

UNUSUAL TEMPORARY DOLLAR PROPS

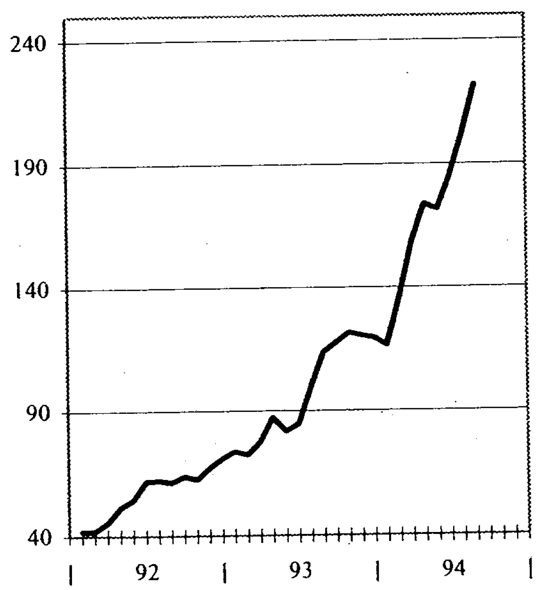
In the 1960s, the U.S. dollar weakened as a flood of U.S. direct investment poured into Europe. In effect, the long-term capital outflows exceeded the sizable U.S. trade surplus that existed then. By 1971, this imbalance had irreversibly wrecked the Bretton Woods System of fixed exchange rates. Once currencies began floating in the early 1970s, the dollar quickly sank due to a growing U.S. current-account deficit — though still modest — and a near full-fledged capital flight as American political and economic ills mounted. In the 1980s, as we noted, a soaring current-account deficit was largely offset by increasing capital inflows. But now here in the 1990s, for the first time ever, both the current and the long-term capital accounts have fallen deeply into the red as never before.

Considering the resulting yawning gaps in the U.S. balance of payments, it's not the dollar's weakness that has surprised us but its resilience to these devastating trends. In fact, it even rallied for a time in 1993. What actually underpinned the U.S. currency and prevented its collapse were two extremely unusual sources of support: first, record-high Euro-dollar borrowing by U.S. banks; and second, record dollar purchases by foreign central banks.

It's a mysterious thing that has been happening in the U.S. banking sector and in the international money markets. For more than a year, U.S. banks have experienced zero growth in customer deposits as reflected in the very weak broad money growth (M2). In terms of customer deposits, the U.S. banks are actually in an unprecedented tight-money situation. Yet loans and bank purchases of bonds have risen. To finance this expansion, the U.S. banks resorted to borrowing from foreign banks as never before.

We need to put these flows into perspective: The previous record-high in Euro-dollar borrowing occurred in 1987 at an annual rate of $44 billion. In recent months, this activity has been running at an annual rate of about $200 billion. By far, it has become the main funding source of the U.S. banks.

U.S. BANKS: FOREIGN LIABILITES
$ Billions, Monthly



Source: U.S. Federal Reserve

What should we make of these facts? Clearly, this surge in Euro-dollar borrowing has played a crucial role in propping up the U.S. dollar. But the motive for foreign lenders to accommodate such borrowing is obscure to say the least.

In its latest report on U.S. international transactions, the U.S. Commerce Department offers this explanation: "*The supply of funds from abroad was encouraged by the run-up in U.S. short-term rates at a time when most foreign rates were stable or declining.*

This explanation defies logic. U.S. short-term interest rates remain the lowest in the world (outside of Japan) despite all the Fed's huffing and puffing in its modest tightening actions. And in Japan, where short rates are lower, banks and investors are among the few international operators who are reducing, not raising, their dollar exposure. The Commerce Department's answer therefore can't be correct.

So why have foreign banks poured more than $100 billion into a currency with low interest rates? The only explanation we can offer is that they must be overwhelmingly bullish on the dollar, betting on its rise. It's such an incredible development that it's simply hard to believe. But if it's true, it spells disaster for the dollar once the foreign lenders realize their error.

OTHER ACTORS IN THE DOLLAR DELUSION

One other special group of institutions came to the dollar's rescue besides the Euro-markets: foreign central banks. They were large buyers of dollars over the past year, purchasing a record $71 billion. The major buyers were the Bank of Japan and the central banks of developing countries. The total dollar holdings of all the world's central banks have now ballooned to about $520 billion. That compares to an approximate level of only $100 billion in the early 1980s.

Nevertheless, the dollar bulls have not given up hope. The stock and bond market bulls haven't either. Essentially, the well-being of these three markets is interlinked. Dollar strength depends on uninterrupted and large capital inflows which, in turn, require permanently bullish U.S. financial markets and vice versa. Apparently, the bulls expect that Mr. Greenspan will be able to deliver this miracle.

Underlying this mutual bullishness is the perception of sustained, healthy U.S. economic growth characterized by low inflation and driven by strong investment, superior productivity and sharp profit gains. They couldn't be more wrong.

To begin with, this U.S. recovery — despite its apparent display of strength over the past few quarters — is still the most ill-structured ever. Its main engine has been the mortgage refinancing boom. As mortgage rates fell from 10% in early 1991 to a low of 6.75% last October, consumers seized the chance to switch to lower-rate loans. But instead of consolidating their finances, they used the decline in their debt-service costs to expand their debt leverage even more. For the debt-addicted households, it was like the land of milk and honey. Lower debt payments meant room for more debt and consumption.

AN INCOME CLASH WITH CONSUMPTION

Despite widespread chatter about an investment- and productivity-led U.S. recovery, the facts show otherwise. Last year, consumption accounted for 77% of real U.S. GDP growth. This compares to an already-high average of 68% of GDP growth in the 1980s. Add housing investment — to an extent, also a form of consumption — and the ratio rises to 87% of 1993 GDP growth, up from an average 74% in the 1980s. Even for America, this consumption boom is unprecedented.

Seen in relation to the disastrous real income growth, this consumption boom is simply preposterous After 13 quarters of expansion, personal disposable income is up a scant 4.1% as compared to an average gain of 11.2% over the same time span of previous postwar recoveries.

Actually, real income growth halved to 1.5% in 1993 from a rate of 3.1% in 1992. Wage and salary growth fell steeply last year. In real terms, disposable income growth of $56 billion in 1993 coincided with spending growth of $109 billion. Looking at these startling figures, we can only shake our heads in amazement over the general perception of healthy income-driven consumer spending in the United States. It's simply a continuation of the same disease that has weakened the foundations of the U.S. economy over the past several decades. Forget the sweet stories of the bulls. The U.S. and all of the other countries afflicted with the same disease — with the possible exception of New Zealand — are far from veering off this destructive path.

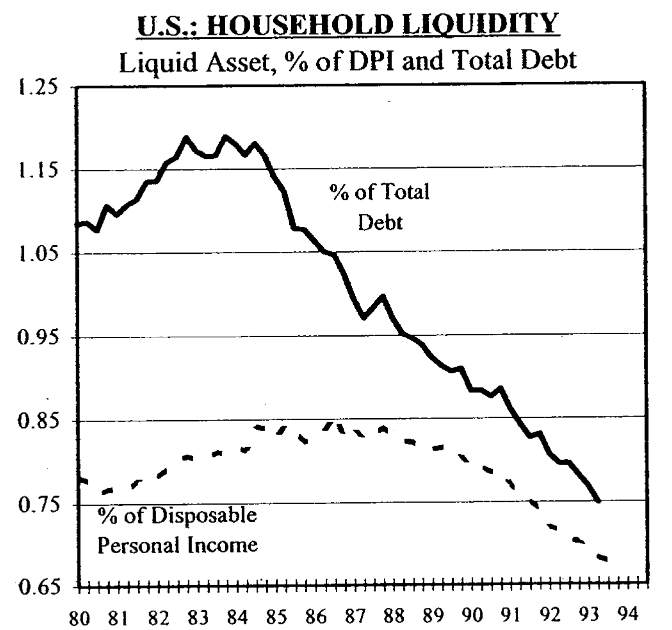
Yet, surveys show that the American consumer remains fiercely optimistic. Deprived of the easy cash flow from mortgage refinancing, many have turned to the crutch of their credit cards as they did in the 1980s. Consumer installment credit once again is growing at double-digit rates. Meanwhile, interest rates are rising.

Optimism is hardly enough to live on, let alone to maintain high spending. Ultimately, high living requires income and cash; easy credit won't suffice indefinitely. Here we see that the U.S. consumer is in the worst fix of the entire postwar period. For one, the ratio of debt-to-disposable-income is rising back to the record highs of the late 1980s. Critically, in the meantime, liquidity (as measured by household bank deposits and money funds) is falling to ever lower lows. The graph on the next page highlights the unprecedented gravity of this condition. What makes it worse now is that weaker financial markets are nibbling away at household wealth.

THE MONEY NOOSE

In the same vein, monetary indicators show a progressive liquidity squeeze. Broad money aggregates have been rather flat for years, and narrow money growth, which had soared since 1991, has abruptly come to a halt this year.

Are the monetary aggregates relevant? Conventional wisdom says "no." The experts — even in the Fed — shrug their shoulders and comfort themselves with the notion that the traditional relationship between the money supply and GDP has changed. Therefore, so they conclude, this link can safely be discarded as a guide for monetary policy. No attempt is made to investigate the causes and the implications of this extremely abnormal money behaviour.



Source: Federal Reserve Board, Flow of Funds

But this ignores the unchanging truth: Money supply ultimately determines the available liquidity in an economy. Diminishing money balances mean diminishing liquidity even if its adverse effects on the economy and the markets are temporarily concealed by accelerated money circulation — described in technical terms, as we showed in the last letter, by increasing money velocity.

True, the U.S. economy has continued to expand and financial markets have even boomed defying the slumping money growth. It is a feat that is unprecedented in postwar history. But it is important to see what made this unique situation possible even if only temporarily. Low nominal and sub-zero real short-term rates have unleashed a huge migration of capital through a number of channels: Firstly, a race out of cash and into mutual funds; and secondly, soaring short-term borrowing and lending through the intermediation of non-bank financial institutions. Peculiar to both flows is that they leave the total money stock unchanged. Yet, they impact the markets and the economy by raising the velocity of money circulation.

To get a real picture of what has happened, one needs to visualize the following: During the four-and-a half years since the end of 1989, investors poured trillions of dollars into the U.S. financial markets. Yet, broad money (M3) — that is actual liquidity — rose a mere $146 billion, most of which — $125 billion — was in increased currency-in-circulation (paper money) much of which the Fed claims has flowed out of the country. Currency-in-circulation doesn't represent real liquidity.

A RUSH FOR LIQUIDITY: THE CATALYST FOR A CRASH

The refinancing binge is over ... the bust has begun ... so to speak, the major trend is set. That's the hard, irrevocable fact which is bound to defeat the false optimism that still widely prevails. Lumbered with a depleted, over-leveraged balance sheet, the consumer must slash his spending sooner or later. That will be the end of the U.S. recovery and the start of the next phase of a great bear market in stocks, bonds and the U.S. dollar.

Actually, the American consumer is already retrenching — lackluster retail sales, slumping auto sales and housing starts as well as sharply lower purchases of mutual fund shares are the evidence. It's not a "*pause that refreshes*" as so many want to believe; it's the end of the recovery. At the same time, there are early signs of an effort to rebuild cash balances. The long, steep decline of bank CD's and other time deposits has bottomed. Ominously, narrow money growth has also fizzled. What we see is that there's precious little liquidity to go around and early signs of a shift in liquidity preference. It's a huge powder keg on the verge of explosion. A rush for liquidity — the so-called "*dash to cash*" — is the catalyst that could set off an uncontrollable financial crash.

Soaring M1 growth in the past years was a good proxy for the frantic flight from cash into ever more financial speculation. Buying securities required investors to turn time deposits or expiring CD's first into the demand deposits which were needed for their payment. In this way, the frenzied buying and selling in the financial markets boosted both the demand for transaction money and its circulation with the result that M1 growth exploded.

The sudden stagnation of demand-deposit growth since February gives further, clear proof that this formerly abundant fuel-supply for the markets has been cut off. The recirculation of deposits may keep the bubble afloat for awhile and feed the kind of counter-rallies that we are seeing on Wall Street. But we can't get away from this incontrovertible fact: Deprived of new money, the bubble must die.

Those who are waiting for the small investor to rekindle the financial boom with a new surge in mutual fund purchases are waiting in vain. The barrel has been emptied as far as investors and consumers are concerned. To make matters worse, the consumer's liquidity and wealth are sure to be squeezed further through declining stock and bond prices.

THE BIG EXTERNAL LEAK IN THE U.S. MONEY SUPPLY

But, really, what is at the root of the sharp downtrend in U.S. liquidity? Though this trend already started in the late 1980s, it has accelerated sharply in the 1990s despite an extremely loose monetary policy. How can loose money lead to illiquidity? Very simply — by causing or allowing prolonged spending in excess of current income.

Such overspending can be accommodated in two ways: Either through increased borrowing or by drawing down existing money balances. This time, taken together, the American consumer did both to an unprecedented degree. The biggest influence, as we have stressed, has been the velocity effect — the massive switching out of cash into securities.

Yet, the abnormal weakness in U.S. money and liquidity trends have still another major cause that's never mentioned: It's the huge external deficits of the U.S. current and long-term capital-accounts. Essentially, both outflows result in a transfer of dollar balances from domestic accounts into foreign bank accounts. In this way, the two external deficits act as a powerful suction pump on U.S. domestic money and liquidity.

Oddly, the enormous contractive effect of these two external deficits on domestic liquidity is entirely ignored. Actually, these dollar outflows mostly end up as Euro-dollar deposits in foreign hands ... that is in foreign banks and overseas branches of U.S. banks.

In the 1980s, the dollar outflows through the current-account deficit were promptly and fully recycled back into the U.S. economy and its financial markets. Therefore, these dollars were automatically returned to the U.S. money supply. But now that this recycling conduit has broken down, the external

deficit has become a drain on the domestic money supply, involving a corresponding decrease in bank deposits.

Still, the huge U.S. external deficit has been financed. Otherwise, it couldn't exist. The key point is that it was financed through the Euro-interbank market, as U.S. banks funded their domestic credit expansion and bond purchases by borrowing heavily from foreign banks. (The Euro-dollar liabilities of the U.S. banks are not part of the U.S. money supply.)

These interbank financial flows have rescued the dollar over the short-run. However, how long is this sustainable? Definitely, it's the most precarious kind of bank financing. In fact, the banks are already cutting back on their bond purchases, though not on their loan expansion. This begs the question: What happens to the dollar and U.S. financial markets when the dollar-lending foreign banks finally become truly bearish on the dollar?

A STAGE SET FOR A CRASH

The Greenspan Fed is widely praised for its cunning role in stabilizing the tottering U.S. banking system while at the same time stimulating the U.S. recovery. But what has the Fed really done? It has crafted a remedy by stoking an unprecedented speculative bubble in the financial markets and causing even greater imbalances elsewhere. The Fed may have solved its most pressing problem — a hemorrhaging banking system — but only at the expense of fomenting even greater ones that will be much harder to remedy than the first one.

The Fed's rate hikes this year were declared to be pre-emptive strikes against inflation. That may have been the motivation, but in our view, the Fed had to act chiefly because the previously-imposed, artificially low rates, were dangerously disequilibrating the economy and the whole financial system by grossly inflating the demand for securities at the expense of cash balances.

The Fed should have known that the rate hikes, though modest so far, would place the markets, the economy and the financial system into jeopardy. In the first place, higher rates will tend to raise the demand for money, reversing its collapse. Given the near absence of new money (liquidity) creation, this development alone would already be sufficient to crunch the economy and the U.S. financial markets.

What about inflation? True, the U.S. recovery, though feeble, has sparked flickers of cyclical inflation at its atrophied inflation-prone manufacturing base. Though these small shimmerings may act as the catalyst that finally unveils the true depravity of the U.S. liquidity situation, they are not the root cause. Behind the near-term overheating in the economy we see the continuation of an ongoing liquidity contraction. This is the key legacy and the real danger. Can it be arrested and reversed? As we said in the last letter: "*Bubbles can only be prevented, never cured.*"

We think that the U.S. Fed has already lost control, though it may not know it yet. This giant, runaway speculative mania that the Fed has nurtured during the past few years — the Great Financial Bubble, the biggest in modern history — inevitably will have its way, the way of all bubbles — a huge bust. The stage is set for a crash. Only the timing is up for question.

CONCLUSIONS

The U.S. economy is both weaker and slowing faster than most people think. But since a slowdown is seen to stave off new rate hikes by the Fed, it tends to boost financial markets, and even has shored up the dollar.

It's truly absurd. Before, we were told that the dollar would rise on the back of increasing short-term interest rates. Now the dollar bulls are cheered by the belief that a weaker economy, by preventing new rate hikes, will stimulate foreign demand for U.S. bonds and thus strengthen the dollar.

Once the markets begin to realize that the U.S. economic recovery is being aborted, it will send the dollar and the U.S. securities markets tumbling.

Now that the international credit-driven, international bond market bubble has burst, an emerging global capital scarcity — caused by record-low savings and record-high budget deficits — will hold long-term rates at high levels, regardless of low short-term interest rate levels.

The most vulnerable markets and currencies are essentially those of the world's big deficit and debtor nations, including the United States.

Remember these facts: Global supply-demand conditions for capital are disastrous as never before; in some countries, particularly in the United States, a liquidity crunch is developing.

Market rallies — reflecting nothing more than the hectic actions of short-term traders and short-covering — should be seen as a gift — for selling rather than buying.

We continue to maintain a strong preference for the hard currencies countries — Germany, Switzerland, Austria and the Netherlands. Above all, hold on to liquidity. Only focus on cash securities and shorter-term bonds.

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